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TAX FORUM

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TAX ADMINISTRATION 1972-73

At a recent appearance before a subcommittee of the House Committee on Appropriations, officials of the Treasury Department and the Internal Revenue Service provided some insight into their plans for the fiscal year 1972-73. Among items discussed were three that will directly affect the conduct of IRS tax investigations and audits during the coming year.

Economic Stabilization Program—"Caveat Emptor"

It is the intent of the IRS to move more actively into the economic stabilization program by simultaneously running double audits that will encompass a review of the taxpayer's compliance with price and wage controls as well as with the tax laws. Secretary of the Treasury John Connally stated that he and Commissioner Walters of the Internal Revenue Service have made a decision that an Internal Revenue agent who is conducting a tax investigation for whatever reason could concurrently check on prices or wages. Conversely, if he is there primarily to check on compliance with the Pay Board regulations or price commission orders, he could also, if necessary, carry out the normal function of an Internal Revenue agent with respect to income tax returns.

In light of the provisions of Revenue Ruling 72-236 (C.B. 72-20, p. 7, 5/15/72) a lack of compliance with price and wage controls could be a costly situation for all taxpayers, including companies now exempt from such controls. (Generally, those companies with 60 or fewer employees and less than $50 million in annual sales who are not in the health or construction industries—CLC (Cost-of-Living Council) Reg. 101.51.) Rev. Rul. 72-236 provides that no deduction as an ordinary and necessary business expense will be allowed for tax purposes if the payment of wages, salaries, rent or any price item is in violation of the amount permitted under Executive Order 11640. The basis for the disallowance stipulated in Rev. Rul. 72-236 is Code Section 162(c) (2) which provides in part that no deduction (as a trade or business expense) shall be allowed for any payment constituting an illegal payment under any law of the United States. Section 1(a) of Executive Order 11640 includes the provision that "No person shall charge, assess, or receive, or knowingly pay or offer to pay, directly or indirectly, in any transaction, prices or rents in any form higher than those permitted hereunder, and no person shall, directly or indirectly, pay or agree to pay, in any transaction, wages or salaries in any form, or to use any means to obtain payment of wages and salaries in any form, higher than those permitted hereunder, whether by retroactive increase or otherwise."

In determining how an exempt taxpayer might be affected, let us take a hypothetical situation: An IRS agent in the process of an examination of Company L, a Tier II taxpayer subject to wage-price controls, discovers that the company is charging excessive prices for material sold to customers. Among these is Company S, a Tier III taxpayer exempt from controls. Question: In addition to levying penalties against L for an infraction of the Price Control law, can the Service look through to Company L's buyer and assess a tax deficiency on any tax return in which the excess portion of prices paid by S has been used in computing cost of goods sold? Presumably, since the excess is classified as an illegal payment, the answer could be yes. Whether S might avoid the additional assessment as an exempt entity or by claiming that it unknowingly made excessive payments is speculative. In order to prevent such a situation from arising, a buyer would be wise to determine that he pays prices no higher than allowed by the price commission. In other words, "let the buyer beware"—not only of quality, but of overpricing.

Computer Audits

Commissioner Walters also discussed computer assisted techniques now being used by revenue agents for examining firms with computerized accounting systems. Computer assisted audits are presently being conducted in the larger IRS districts, and plans are to have these techniques available to most agents during 1973.

The history and planning of computer audits go back at least as far as 1964 when Rev. Proc. 64-12 established the guidelines for keeping records within an EDP system. Code Section 6001 and the regulations thereunder provide the requirement for maintaining adequate records. On January 18, 1971, the IRS issued Rev. Rul. 71-20 classifying machine-sensible data as "records" and placing this information on the same legal retention basis as paper or hardcopy records. Included among machine-sensible data media are punched cards, magnetic tapes, disks, etc.

The Service has stated that it is not intended that all record media be retained, only the records the IRS considers necessary for future tax audits. In order to keep these at a minimum, IRS personnel are available to evaluate a taxpayer's records and enter into a written agreement specifying the ones to be retained. (The writer's one experience in this area indicates that, during the period of time such an agreement is in force, the taxpayer's obligation under Rev. Rul. 71-20 will be satisfied.) If there is a program change as a result of an alteration in accounting procedure, etc., the Service should be advised. Guidelines have been issued to all district offices and training courses have been established to insure that agents are qualified to make adequate evaluations. Martin Roberts, Assistant Professor, Georgia State University, who has been working with the IRS as a consultant on computer audits, has written two articles in the March 1971 and June 1971 *Tax Advisor* containing the majority of the IRS guidelines.

The Service's attitude toward implementing the guidelines is one of flexibility both in adapting its procedures to various taxpayer situatons and in working with taxpayers on potential problems that may arise. IRS officials have emphasized that, as technical advances are made in computer methodology, Rev. Rul. 71-20 will require updating. It should be noted that Rev. Proc. 64-12 has not been revoked and is still in effect. This procedure has frequently been incorrectly interpreted as requiring the retention of hardcopy records when, in fact, it has a provision that requires only the ability to print hardcopy records. This means that a taxpayer is not bound to maintain both hardcopy and machine-sensible data as long as there is the capacity available to print hardcopy records when needed. However, if a taxpayer has printed hardcopies for his own use, the Service has suggested that these be retained as possible source documents during a tax audit in the event that machine-sensible data prove inadequate due to incompatability, deterioration or programming problems. Rev. Proc. 64-12 also provides that a taxpayer may destroy the machine-sensible data after an examination has been completed, but it would be necessary to retain hardcopy to back up the data destroyed.

Taxpayers with heavily automated accounting systems should remain current on changes in the guidelines for record retention and, if possible, reach agreements with local IRS officials as to their individual retention requirements in order not to be burdened with unnecessary storage of superfluous information.

Team Audits

Mr. Walters went on to say that, in an effort to focus on high-yield areas, the IRS has instituted a coordinated examination program that uses teams of audit specialists to examine large cases, including some that are international in scope. This program places primary responsibility for audits in key districts where the audits are centrally planned and managed. In many ways this approach is not unlike the audit program drafted by a certified public accountant in preparing to review the financial statements on which he is to render an independent opinion. (The programs may prove more comparable in theory, however, than in actual application.) Presently, the Service has some 1500 large cases involving 45,000 separate business entities which it considers as needing audit attention. Among this group the tax deficiencies identified at the time of the Committee hearing amounted to over $2.5 billion. It appears that through more sophisticated audit procedures the IRS will net some rather large "fish" from the "Sea of Revenue."

After selecting the taxpayer to be examined, a Large Case Audit Plan is transmitted to the company(ies) on Form 4764. The plan is prepared by an acting case manager from the district office and in general includes the following information:

(a) — Name and position or specialty of the Internal Revenue Service personnel assigned to the examination; i.e., J. Smith — Case Manager, R. Jones — Team Coordinator, W. Black — International Specialist.
(b) — Taxpayer's personnel to be contacted and the information for which they will be responsible; i.e., G. Black, Controller, all corporations, L. Green, President, XYZ corporations and subsidiaries.
(c) — Examination schedule setting forth the corporate entities to be examined, the site, records location, agents assigned to each entity and the scheduled starting and completion dates.

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be considered compensatory—and some charge against income will be necessary.

Compensatory Plans

In the compensatory plans, the price received for the stock is recorded as the cash (or other assets) received plus the services performed by the employee. The catch being, of course, how to determine what the value of the "services received" may be. The Board concludes that such compensation should be measured by the "quoted market price of the stock at the measurement date less the amount, if any, that the employee is required to pay." This is a modification of the principles set forth in ARB 43, Chapter 13B, insofar as the meaning of "fair value" of the stock and also the "measurement date" are concerned.

The "measurement date" is set forth as that date on which both the number of shares and the purchase price are known—usually the date the award is granted, but it may be a later date in plans with variable terms which depend on events after the date of award. (At this point, the draft describes the principle in some detail for special situations.)

The draft then proceeds to explain that the compensation costs should be considered an expense of the period in which the employee performs services. Again, complications result because those services will probably extend beyond one accounting period, or because the stock may be issued before the services are performed. In such an event, the accountant must accrue the expense—and such accrual may often have to be an estimate, with adjustments to those estimates to come in later periods.

Obviously, the corporation recognizes no compensation cost if the employee pays an amount at least equal to the quoted market price at the measurement date.

Income Tax Benefits

Because the deduction allowed for income tax purposes may be in different amounts and in a different period than that which the corporation recognizes for financial statement purposes, timing differences may exist and the resultant tax allocation of income taxes may be necessary. A corporation may be entitled to a tax deduction even if there is no compensation expense recorded in computing net income (or the tax deduction may be in excess of the book deduction). In such instances, any "excess" tax reduction should not be included in income but is to be added to capital or, conversely, where tax benefits are less, the difference should be deducted from additional capital (but only to the extent of previous additions to such account through the workings of the same or a similar compensatory stock plan).

Conclusion

This Opinion is to be effective for all awards made after June 30, 1972. It may have been apparent to the Board that this Opinion would be extremely difficult to interpret, and so several illustrative examples are provided in an appendix to demonstrate what the Board considered the most vital distinction of this Opinion—compensatory plans in which the cost of compensation is measured at the date of grant or award—and those in which the cost of compensation depends on events after the date of the grant or award. Even combination plans are described briefly in a final section.

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(d) — Record of pre-examination conferences including the participants, their titles and the date or dates of the conferences.

(e) — A list of books, records, schedules, exhibits and analysis to be available at the start of the examination.

(f) — Space and other facilities to be provided for Service personnel and any other pertinent agreements.

The final page of the audit plan also includes a statement that the plan is a guide for examination and "is subject to revision as progress indicates the need for more, less, or different work than originally planned."

It would seem that the planned audit program should provide the IRS with a definitive and more comprehensive examination of large, multi-operational taxpayers, and may well result in greater tax revenue from closer scrutiny of the so-called "gray" areas of the tax laws that are frequently subject to varying interpretations and much litigation. It may also prove to be beneficial to taxpayers whose records, though complex and detailed because of the magnitude of their operations, are factually correct and within the provisions of pertinent Code sections and regulations. A planned program should eliminate wasted time that might otherwise occur as a result of inexperienced Service personnel examining tax areas in which they might have no expertise.